ARIZONA CORPORATE INCOME TAX OF MULTISTATE BUSINESSES

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1. TAXATION OF MULTI-STATE CORPORATIONS - GENERAL

1.1 LIMITATION IMPOSED BY THE DUE PROCESS AND COMMERCE CLAUSE

(1) Due Process Clause – "Minimum Connection." The Due Process Clause of the 14th Amendment of the U.S. Constitution imposes a two-part test for a state to impose a net income tax: (1) no tax may be imposed unless there is some minimal connection between the activities of the taxpayer and the taxing state; and (2) the income attributed to the taxing state must be rationally related to values connected with the state imposing the tax. *Exxon Corp. v. Department of Revenue*, 100 S. Ct. 2109 (1980); *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 100 S. Ct. 1223 (1980); *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 98 S. Ct. 2340 (1978), *reh'g denied*, 439 U.S. 885, 99 S. Ct. 233.

(2) Commerce Clause – "Four Part Test" of Complete Auto Transit. The Commerce Clause also restricts a state's ability to impose an income tax on a multi-state corporation. In addition to restricting a state's ability to tax income derived from interstate commerce (such a tax can't unduly burden interstate commerce), the Commerce Clause also requires that a state's tax be imposed only on activities that have a substantial "nexus" with the taxing state. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 279, 97 S. Ct. 1076 (1977).

Under *Complete Auto*, a tax on interstate commerce is constitutional if it meets the following four-part test:

1. The tax is applied to an activity with a substantial nexus to the taxing state;

2. the tax is fairly apportioned;

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3. the tax does not discriminate against interstate commerce; and

4. the tax is fairly related to the services provided by the state.

1.2 DETERMINING A MUTISTATE CORPORATION'S IN-STATE INCOME

(1) General.

In light of the restrictions imposed by the Due Process and Commerce Clauses of the U.S. Constitution, it is necessary to determine what portion of a multi-state corporation's income is derived from in-state sources."

In complying with the Due Process and Commerce Clause restrictions, the states use two basic methods for determining the income a multi-state corporation earns within their borders: separate accounting and formula apportionment.

(2) Separate Accounting.

Separate accounting, used less frequently than formula apportionment, is sometimes applied when a business is able to accurately separate income-producing activities and income sources within a particular state from income-producing activities and income sources in other states. This state-by-state determination requires verifying numerous intercorporate transactions to compute the proper value for goods and services exchanged between the related entities. This is a time consuming task, involving the potential for thousands of transactions. State tax administrators and corporate taxpayers generally agree that under the separate accounting method:

(1) the cost of preparing tax returns and the time required to audit those returns is generally greater;

(2) the allocation of indirect expenses--such as advertising costs--among the corporate entities is based on arbitrary criteria which can vary from one corporation to another; and

(3) the determination of fair and reasonable selling prices for goods exchanged between corporate entities is difficult.

Because of these difficulties and doubts about the applicability of separate accounting to some types of businesses, the states generally use separate accounting only to determine the income certain kinds of multi-state corporations earned within their jurisdictions. These businesses, primarily general merchandising, oil and gas, and construction companies, use separate accounting because it conforms more to their financial accounting procedures and more accurately reflects income than formula apportionment. For example, a construction firm normally determines profitability on an individual project basis, calculating revenues and costs separately for each project. *See* General Accounting Office, Report to the Chairman, House Committee on Ways and Means, "Key Issues Affecting State Taxation of Multi-State Jurisdictional Corporate Income Need Resolving," July 1, 1982, pages 2 and 3 (the "GAO Report").

(3) Formula Apportionment.

All 45 states which impose an income tax rely primarily on formulas to apportion a corporation's income among those states in which the corporation does business. Apportionment

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formulas attribute income to the states on the basis of factors which produce the income. The factors most commonly used are property, payroll and sales. To derive the amount of income taxable in the state, the value of each factor in a state is first compared to the total value of that factor for the corporation. The formula used by most is:[1]

THREE FACTOR FORMULA

$$\frac{\frac{\text{In-State property}}{\text{Total Property}} + \frac{\text{In-State payroll}}{\text{Total Payroll}} + \frac{\text{In-State sales}}{\text{Total sales}}}{3} \times \text{Total corporate income} = \text{Income taxable by the State}$$

When required by a state to use formula apportionment, a multi-state corporation usually begins by adjusting its federal taxable income for items which the state treats differently from federal law (e.g. the additions and subtractions required by A.R.S. § 42-1121 and 1122) and for income items not subject to the apportionment formula. The types and amounts of income not subject to formula apportionment, such as dividends and interest, vary among the states. Those income items which are not apportioned among the states are normally taxed and totaled by one state. This procedure is known as “allocation” -- that is, the total amount of these income items is allocated to one state. Depending on the individual state rules, the state to which the income is allocated may be determined by the location of: (1) the corporate headquarters, (2) the assets producing the income, (3) the activity producing the income, or (4) the entity which paid income to the taxpayer.

Once a corporation determines the income to be apportioned, it applies a formula, such as the one shown above, to that income to calculate the amount to be apportioned to an individual state. Under the formula apportionment method, the multi-state corporation's income a state may tax consists of the income specifically allocated to the state *plus* the income derived from application of the apportionment formula.

Note, however, that the states do not apply the formula apportionment in all cases. In order to properly apply formula apportionment, the business operation of the corporation, both within the state and outside the state, must be "unitary." A unitary business may be comprised of branches or divisions of a single corporation or commonly controlled but separate corporations. The criteria usually applied for determining if the operations of a business are unitary include: the percentage of one corporation's stock owned by another; the sharing of centralized services, such as accounting and advertising; and the type and number of transactions carried out between corporate entities (the "unitary" concept is covered in detail in Section 5 of this Outline). *See* GAO Report pages 3 and 4.

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1 Arizona double weights the sales factor, otherwise Arizona's formula is the same. *See* A.R.S. § 43-1139.

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1.3 CONSTITUTIONALITY OF APPORTIONMENT FORMULAS

Several U.S. Supreme Court cases have addressed whether apportionment formulas comply with the due process or commerce clause provisions. Generally, the cases have upheld the challenged formulas and allowed even single factor formulas to be used to apportion tax to the particular state.

Single Property Factor OK. In ***Underwood Typewriter v. Chamberlain***, 254 U.S. 113 (1920) the State of Connecticut used a single apportionment factor, the property factor, to allocate 47% of Underwood's income to Connecticut even though only 3% of its income was generated by transactions in Connecticut. The Court upheld the use of the single factor as constitutional. The Court also upheld use of a single factor apportionment formula in *Bask, Ratcliff & Gretton, Ltd. v. State Tax Commission*, 266 U.S. 271 (1924).

Single Factor Unreasonable. However, the use of a single factor was overturned in ***Hans Rees' Sons, Inc. v. State of North Carolina***, 283 U.S. 123, 51 S.Ct. 385 (1931), where the Court found that a roughly 60% disparity between the income found to be North Carolina source and the income allocated to North Carolina by the single factor, was arbitrary and unreasonable. The Court stated:

> Nor can the evidence be put aside in the view that it merely discloses such negligible criticisms in allocation of income as are inseparable from the practical administration of a taxing system in which apportionment with mathematical exactness is impossible. The evidence in this instance, as the state court puts it, "tends to show that for the year 1923, 1924, 1925, and 1926, the average income having its source in the manufacturing and tanning operations with the State of North Carolina was seventeen percent," while under the assessments in question there was allocated to the State of North Carolina approximately 80 percent of the appellant's income . . . It is sufficient to say that, in any aspect of the evidence, and upon the assumption made by the state court with respect to the facts shown, the statutory method, as applied to the appellant's business for the years in question operated unreasonably and arbitrarily, in attributing to North Carolina a percentage of income out of all appropriate proportion to the business transacted by the appellant in that state. In this view, the taxes as laid were beyond the state's authority. 283 U.S. at 134, 136, 51 S. Ct. at 389.

The general standard for evaluating the representativeness of an apportionment formula was articulated in *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159, 103 S. Ct. 2933 (1983) where the Court stated as follows:

> Having determined that a certain set of activities constitute a "unitary business," a State must then apply a formula apportioning the income of that business within and without the State. Such an apportionment formula must, under both the Due Process and Commerce Clauses, be fair. [citations omitted]. . . The second and more difficult requirement is what might be called external consistency - the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated . . . Nevertheless, we will strike down the application of an apportionment formula if the taxpayer can prove by "'clear and cogent' evidence that the income attributed to the State is in fact 'out of all appropriate proportions to the business

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> transacted . . . in that State' [*Hans Rees' Sons, Inc.*], 283 U.S. at 135, 51 S. Ct. at 389, or has 'led to a grossly distorted result,' [*Norfolk & Western R. Co. v. State Tax Comm'n*, 390 U.S. 317, 326, 88 S. Ct. 995, 101, 19 L. Ed. 2d 1201 (1968)]." *Moorman Mfg. Co.*, [437 U.S. 267, 274, 98 S. Ct. 2340, 2345.]. 463 U.S. at 169-70, 103 S. Ct. at 2942.

Single Sales Factor OK. In ***Moorman Manufacturing Co. v. Bair***, 431 U.S. 267 (1978), the Court upheld a single factor apportionment formula, using only sales.

2. TAXATION OF A MULTI-STATE CORPORATION BY ARIZONA--FORMULA APPORTIONMENT AND UDIPTA

2.1 ONLY "ARIZONA SOURCE INCOME" IS TAXED

In addition to Commerce and Due Process Clause restrictions, the Arizona Legislature declared its intent in A.R.S. § 43-102.A.5 "to impose on . . . each corporation with a business situs in this state a tax measured by taxable income which is the result of activity within or derived from sources within this state." In turn, A.R.S. § 43-104.9 defines the phrase "income derived from or attributable to sources within this state" to include "income from tangible or intangible property located or having a situs in this state and income from any activities carried on in this state, regardless of whether carried in intrastate, interstate or foreign commerce." Thus, Arizona is restricted by not only the Commerce and Due Process clauses, but by statute to taxing only in-state income.

2.2 ARIZONA USES THE FORMULA APPORTIONMENT OF "UDIPTA TO DETERMINE IN-STATE INCOME."

When a multi-state corporation is doing business both within and without Arizona, Arizona uses the formula apportionment method to determine the multi-state corporation's Arizona source income subject to Arizona taxation. Arizona has adopted the three-factor formula apportionment methodology provided by the Uniform Division of Income for Tax Purposes Act ("UDIPTA"). UDIPTA is a uniform law which has been adopted by 24 states. Arizona adopted it in 1983 and it became effective for all tax years beginning from and after December 31, 1983. UDIPTA is found at A.R.S. § 43-1131 through 1150. The following portion of the Outline discusses the Uniform Division of Income for Tax Purposes Act.

2.3 TAXPAYERS SUBJECT TO UDIPTA

(1) General.

UDIPTA applies to any taxpayer who has income from business activity which is taxable both within and without the State of Arizona. A.R.S. § 43-1131.7 and 43-1132. It applies to corporations, partnerships and sole proprietorships. The form of the business is not a factor.

(2) Public Utilities and Financial Institutions.

The Uniform Act excludes public utilities and financial institutions from the allocation and apportionment provisions of UDIPTA. However, Arizona's current version of

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UDIPTA applies to both to financial institutions and public utilities. A.R.S. § 43-1132.A and Section 2 of UDIPTA.

2.4 UDIPTA'S PURPOSE

UDIPTA's purpose is to ensure that 100% of a business's income (*no* more and *no* less) is taxed by the various states (that have income taxes) in which the taxpayer conducts its business. UDIPTA is meant to avoid the situations where a taxpayer (1) will only be taxed on less than the full 100% of its total income by the various states (which have income taxes) in which the taxpayer conducts business; or (2) will be taxed on more than 100% of its total income by the various states (which have income taxes) in which the taxpayer conducts business.

2.5 HOW UDIPTA IS STRUCTURED TO ACCOMPLISH ITS PURPOSE

UDIPTA divides a business's income into "business income" and "nonbusiness income." "Nonbusiness income" is specifically allocated to a particular state. "Business income," on the other hand, is apportioned using the "three-factor formula" to the states the taxpayer is doing business in.

2.6 SPECIFIC ALLOCATION OF "NONBUSINESS INCOME"

(1) Definition of "Nonbusiness Income."

"Nonbusiness income" means "all income other than business income." A.R.S. § 43-1131.4.

(2) General Rule--Allocate Nonbusiness Income.

Rents and royalties from real or tangible personal property, capital gains, interest, dividends or patent or copyright royalties, to the extent that they constitute non-business income, are allocated as specifically provided for by UDIPTA (*see* the following subsections). A.R.S. § 43-1134.

(3) Net Rents and Royalties.

Real Property. Net rents and royalties from real property located in Arizona are allocable to Arizona. A.R.S. § 43-1135.A.

Personal Property. Net rents and royalties from tangible personal property are allocable to Arizona either: (1) If and to the extent the properties are utilized in Arizona. (2) In their entirety if the taxpayer's commercial domicile is in Arizona and the taxpayer is not organized under the laws of or taxable in the state in which the property is utilized. A.R.S. § 43-1135.B.

Utilization of Personal Property in a State. The extent of utilization of tangible personal property in a state is determined by multiplying the rents and royalties by a fraction, the numerator of which is the number of days of physical location of the property in the state during the rent or royalty period in the taxable year and the denominator of which is the number of days of

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physical location of the property everywhere during all rental or royalty periods in the taxable year. If the physical location of the property during the rental or royalty period is unknown or unascertainable by the taxpayer, tangible personal property is utilized in the state in which the property was located at the time the rental or royalty payer obtained possession. A.R.S. § 43-1135.C.

(4) Capital Gains and Losses.

Real Property. Capital gains and losses from sales of real property located in Arizona are allocable to Arizona. A.R.S. § 43-1136.A.

Tangible Personal Property. Capital gains and losses from the sales of tangible personal property are allocable to Arizona if either:

(1) The property had a situs in Arizona at the time of the sale.

(2) The taxpayer's commercial domicile is in Arizona and the taxpayer is not taxable in the state in which the property had a situs. A.R.S. § 43-1136.B.

Intangible Personal Property. Capital gains and losses from the sales of intangible personal property are allocable to Arizona if the taxpayer's commercial domicile is in Arizona. A.R.S. § 43-1136.C.

(5) Interest and Dividends.

Interest and dividends are allocable to Arizona if the taxpayer's commercial domicile is in Arizona unless the interest or dividend constitutes business income. A.R.S. § 43-1137.

(6) Patent and Copyright Royalties.

General Rule. Patent and copyright royalties are allocable to Arizona either:

(1) if and to the extent that the patent or copyright is utilized by the payer in Arizona;

(2) if and to the extent that the patent or copyright is utilized by the payer in a state in which the taxpayer is not taxable and the taxpayer's commercial domicile is in Arizona. A.R.S. § 43-1138.A.

Utilization Of Patent in a State. A patent is utilized in a state to the extent that it is employed in production, in fabrication, manufacturing or the processing in the state or to the extent that a patented product is produced in the state. If the basis of receipts from patent royalties does not permit allocation to states or if the accounting procedures do not reflect states of utilization, the patent is utilized in the state in which the taxpayer's commercial domicile is located. A.R.S. § 43-1138.B.

Utilization of Copyright in a State. A copyright is utilized in a state to the extent that printing or other publication originates in the state. If the basis of receipts from copyright royalties does not permit allocations to states or if the accounting procedures do not reflect states of utilization, the copyright is utilized in the state in which the taxpayer's commercial domicile is located. A.R.S. § 43-1138.

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2.7 APPORTIONMENT OF BUSINESS INCOME

(1) Definition of "Business Income."

"Business income" means "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." A.R.S. § 43-1131.1.

(2) Rule--Apportion Business Income.

All business income is to be apportioned to Arizona by multiplying the income by a fraction, the numerator of which is a property factor plus the payroll factor plus the sales factor and the denominator of which is three. A.R.S. § 43-1139.

(3) Formula.

The apportionment formula is generally referred to as the "three-factor formula":

CHART NO. 4

THREE FACTOR FORMULA

$$\frac{\frac{\text{Arizona property}}{\text{Total property}} + \frac{\text{Arizona payroll}}{\text{Total payroll}} + \frac{\text{Arizona sales}}{\text{Total sales}} \times 2}{4}$$

(4) Property Factor.

The Factor. The property factor is a fraction, the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented and used in Arizona during the tax period, and the denominator of which is the average value of all the taxpayer's real and tangible personal property owned or rented when used during the tax period other than real and tangible personal property used by a foreign corporation which is not itself subject to the Arizona corporate income tax or an insurance company exempt from tax under 43-1201. A.R.S. § 43-1140.

Valuation of Property. Property owned by the taxpayer is valued at its original cost. Property rented by the taxpayer is valued at eight times the net annual rental rate. Net annual

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rental rate is the annual rental rate paid by the taxpayer less any annual rental rate received by the taxpayer from subrentals. A.R.S. § 43-1141.

Average Value of Property. The average value of property is determined by averaging the values at the beginning and ending of the tax period, but the Department may require the averaging of monthly values during the tax period if reasonably required to reflect the average value of the tax year's property. A.R.S. § 43-1142.

Safe-Harbor Lease. The property in a safe-harbor leasing transaction, if used in the taxpayer's unitary operations, is included in the property factor of the purchaser/lessor at cost and in the property factor of the seller/lessee at eight times the net annual rate. Department of Revenue Letter to Commerce Clearing House.

(5) Payroll Factor.

The Factor. The payroll factor is a fraction, the numerator of which is the total amount paid in Arizona during the tax period by the taxpayer for compensation, and the denominator of which is the total compensation paid everywhere during the tax period other than compensation paid by a foreign corporation which is not itself subject to the Arizona corporate income tax or an insurance company exempt from tax under 43-1201. A.R.S. § 43-1143.

Compensation Paid In State. Compensation is paid in Arizona if any of the following apply:

(1) The individual's service is performed entirely within Arizona.

(2) The individual's service is performed both within and without Arizona, but the service performed without Arizona is incidental to the individual service within Arizona.

(3) Some of the service is performed in the state and the base of operations or, if there is no base of operations, the place from which the service is directed or controlled is not in any state in which some part of the service is performed, but the individual's residence is in Arizona.

Deferred Compensation. Earnings included in a qualified cash or deferred arrangement under Section 401(k) of the Internal Revenue Code ("Code") are included in the Arizona payroll factor. Department of Revenue Letter to Commerce Clearing House.

(6) Sales Factor – Double Weighted.

The Factor. The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in Arizona during the tax period, and the denominator of which is the total sales of the taxpayer everywhere during the tax period other than sales of a foreign corporation which is not itself subject to the Arizona corporate income tax or an insurance company exempt from tax under 43-1201. A.R.S. § 43-1145. The sales factor is double weighted. A.R.S. § 43-1139.

Situs of Sales of Tangible Personal Property. Sales of tangible personal property are in Arizona if any of the following apply:

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(1) The property is delivered or shipped to a purchaser, other than the United States Government, within Arizona regardless of the FOB[2] point or other conditions of the sale.

(2) The property is shipped from an office, store, warehouse, factory or other place of storage in Arizona and the purchaser is the United States Government or the taxpayer is not taxable in the state of the purchaser. A.R.S. § 43-1146.

Situs of Sales of Other Than Tangible Personal Property. Sales, other than sales of tangible personal property, are in Arizona if any of the following apply:

(1) the "income-producing activity" is performed in Arizona; or

(2) the "income-producing activity" is performed both in and outside Arizona and a greater proportion of the income-producing activity is performed in Arizona than in any other state, based on costs of performance. A.R.S. § 43-1151. *See Walter E. Heller Western, Inc. v. Arizona Department of Revenue*, 161 Ariz. 49, 775 P.2d 1113 (1989) (taxpayer's business activity was making loans to Arizona businesses; it argued that its securing funds from its out-of-state parent to make the Arizona loans with, was a cost of performance of its "income producing activity" and thus as to a greater proportion of those activities took place outside Arizona. The Arizona Supreme Court concluded that:

> We hold that "income producing activity" contemplates direct solicitation, negotiation, and sales activities with consumers in this state.
>
> This activity includes the solicitation of new customers, the investigation of potential customers' credit records, and the negotiation and servicing of these contracts in Arizona. Though borrowing of funds may be an important step in Heller Western's financing process, the direct generation of the loans occurred in Arizona. We conclude that Heller Western's sales activity in Arizona constituted the income producing activity contemplated by our tax regulations.
>
> This is also the logical conclusion. Heller Western's costs in procuring the money (which is the "product" that it has "sold" to Arizona customers) are analogous to the costs of a merchandise retailer in procuring his inventory. Heller Western can no more argue that its receipts from Arizona loan consumers should not be taxed due to its out-of-state involvement in procuring its "inventory" than a retailer who is engaged in extensive dealings out of state to buy his merchandise could argue that he should not be taxed on the goods he sells to consumers here.

Safe-Harbor Lease. The net rental income derived by the purchaser/lessor from a safe-harbor lease transaction, if otherwise includable, is included in its sales factor, and the interest

[2] "FOB" means "Free On Board" some location (for example, FOB shipping point; FOB destination). The invoice price includes delivery at seller's expense to that location. Title to the goods usually passes from seller to buyer at the FOB location. UCC Section 2-319(1).

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income derived by the seller/lessee is included in its sales factor. Department of Revenue Letter to Commerce Clearing House.

The Return of Investment Principal Is Not Includable In The Denominator Of The Sales Factor. Walgreen Arizona Drug Company v. Arizona Department of Revenue, 209 Ariz. 71, 97 P.3d 896 (Ct. App. 2004); Petition for Review Denied (Ariz. Supreme Court, 2005). Walgreen operates retail drug stores as its primary business, with 120 stores in Arizona. Walgreen earns interest on short-term investments and typically reinvests the proceeds in similar interest-bearing instruments. The Court characterized this activity as a "treasury function" designed to maintain cash needed to operate the business on a daily basis (working capital). The investments included commercial paper, municipal securities, auction stock, Eurodollar investments, and money markets. In addition to including the dividends and interest received from its investments in the sales factor denominator, Walgreen filed amended returns including the return of principal in the denominator of the sales factor. This inclusion resulted in a smaller amount of taxable income attributable to Arizona, and the taxpayer requested refunds totaling more than $1.3 million, excluding interest. The Department of Revenue denied the refund request, and Walgreen appealed.

The issue presented by this case is whether the return of principal from short-term investments is includable in a corporation's "total sales" pursuant to Arizona's version of the Uniform Division of Income for Tax Purposes Act. Walgreen's position was that the return of principal constituted "gross receipts" under UDIPTA and thus should be included in the denominator of the sales factor. While the Court agreed that including gross receipts from the sale of inventory and the reinvestment of funds in inventory in the sales factor reflects ongoing business activity and does not artificially distort the sales factor, inclusion of unadjusted gross receipts from investment and reinvestment of intangibles does distort the sales factor. The Court concluded that, while interest and dividends were properly included as "gross receipts" in the sales factor, the return of principle was not, relying upon the recent California Appellate Court decision in *General Motors Corp. v. Franchise Tax Board*, 120 Cal. App. 4th 114, 16 Cal. Rptr. 3d 41, *modified on other grounds,* 120 Cal. App. 4th 881, 16 Cal. Rptr. 41 (2004). The Court also relied upon a report issued by the Multistate Tax Commission in 1997 finding that "the inclusion in the sales factor gross receipts from the generally short-term investment and reinvestment of certain intangibles (idle cash) held for the future operation of the taxpayer's business, inherently produces incongruous results."

QUERY: Would and should the result be different, for, say, a dealer in securities or a mortgage company that packages its mortgages and sells them on the secondary market in order to obtain additional funds to acquire more inventory (mortgages)?

The Throw-Back Rule – Repealed effective 1/1/98. The test used under A.R.S. § 43-1146 to determine the situs of the sale is the "destination" of the goods. The throw-back rule acts to expand the sales assigned to a particular state by including certain sales that do not meet the "destination" test. Under the throw-back rule, if the corporation is not taxable in the state of destination, the sale is "thrown back" to the state of origin and included in that state's apportionment calculation. The throwback rule attempts to insure that 100% of a multi-state corporation's sales are assigned to a state that has jurisdiction to tax the corporation. Without a throw-back rule, sales made by a multi-state corporation to destinations and states in which it is not subject to tax are not included in the numerator of the sales factor for any state. These sales become, in effect, "nowhere sales." The overall result is that the sum of the apportionment factors for the various states in which the corporation files returns is less than 100%. The theory behind the throw-back rule is that the corporation should be denied the "opportunity of relying on the normal sales attribution rules to produce a tax-free haven for a portion of its income." Hellerstein "Construing the Uniform Division of Income for Tax Purposes Act: Reflections on the Illinois Supreme Court reading of the Throw-Back Rule," 45 U. Chi. L. Rev. 768, 770 (1978).

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A.R.S. § 43-1146.2 provided the throw-back rule:

> Sales of tangible personal property are in this state if any of the following apply: . . .
>
> 2. The property is shipped from an office, store, warehouse, factory or other place of storage in the state and the purchaser is the United States Government or the taxpayer is not taxable in the state of the purchaser.

The throw-back rule consists of two components. First, the property must be shipped from an office, store, warehouse, factory or other place of storage in Arizona. Second, the purchaser must be the United States Government or the taxpayer is not taxable in the state of destination.

"Sales to the U.S. Government" is a fairly straightforward provision of the throw-back rule but what does "not taxable in the state of destination" mean? A.R.S. § 43-1133 provides that a corporation is taxable in another state if:

> 1. In that state [the taxpayer] is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business or a corporate stock tax.
>
> 2. That state has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does or does not.

The provision that the "state has jurisdiction to subject the taxpayer to a net income tax" only means that the state must be able to exercise its power to tax. The state does not actually have to impose a tax upon the multi-state corporation in order for the corporation to be considered taxable in that state for purposes of avoiding the application of the throw-back rule. *See Miles Laboratories Inc. v. Dept. of Rev.*, 546 P.2d 1081 (Oregon 1976).

Jurisdiction to tax is not present if the state is precluded from taxing because of Public Law 86-272. In such a case, those sales would be "thrown back" to the origination state.

Repeal of Throw Back Rule. The throw back rule was repealed by the 1998 Legislature, specifically by Laws 1998, Fourth Special Session, ch. 3, section 13. The repeal of the throw back rule and the double throw back rule, which is contained in the Department's regulations, is effective for tax years beginning from and after December 31, 1997. Given the repeal of the rule, sales from Arizona into a state where the seller is protected from taxation by P.L. 86-272, will not be "thrown back" to Arizona. As a result, those sales will be "nowhere sales" and will go untaxed.

The Double Throw-Back Rule (also repealed effective January 1, 1998). In addition to the standard throw-back rule, a so-called double throw-back concept is included in the regulatory provisions of the Multi-State Tax Compact and in the Department of Revenue Regulations under UDIPTA. The double throwback rule applies primarily to sales involving the drop shipment of goods--that is, the goods sold are shipped directly by a vendor, from a state in which the taxpayer is not subject to tax, to a customer also located in a state where the taxpayer is not subject to tax. Under the standard throw-back rule, the drop shipment sale would not be included in the state's sales factor because the first component of the throwback rule, "property is shipped from an office, store, warehouse, factory or other place of storage in this state" would not apply. As a result, the drop shipment sale provides a means of circumventing the intent of the standard throw-back rule and of decreasing a corporation's overall sales factor. The double throw-back rule throws the sale first to the vendor's state and if the taxpayer is not taxable there,

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throws it again to the taxpayer's home state (where sales office is). Regulation R15-2-1146.A.7 establishes the double throw-back rule:

> 7. If a taxpayer whose salesman operates from an office located in this state makes a sale to a purchaser in another state in which the taxpayer is not taxable and the property is shipped directly by a third party to the purchaser, the following rules apply:
>
> a. If the taxpayer is taxable in the state from which the third party ships the property, then the sale is in that state.
>
> b. *If the taxpayer is not taxable in the state from which the third party ships property, then the sale is in this state*. [Emphasis supplied.]

The General Motors Case: No Estoppel Regarding Calculation of Sales Factor. In *General Motors Corp. v. Arizona Dep't of Revenue,* 189 Ariz. 86, 938 P.2d 481 (App. 1996) (petition for review denied July 1, 1997), the Court of Appeals concluded that the Department of Revenue, which entered into a prior agreement with the taxpayer concerning the calculation of the sales factor of the three factor apportionment formula (for income tax purposes), was not estopped from not following that agreement for future years when there had been an intervening change in regulations. GM was relying on the *Tucson Electric Power* case but the Court of Appeals disagreed, indicating that choosing the components of the sales factor formula is not a procedural matter, as was involved in the *Tucson Electric Power* case. The Court of Appeals relied upon the *Crane* and *Duhame* cases, and Article 9, Section 1 of the Arizona Constitution (the power of taxation shall not be surrendered), to support its no estoppel holding. GM's petition for review to the Arizona Supreme Court was denied.

(7) New Corporate Super-Weighted Sales Factor Provides Incentive For Capital Investment in Arizona.

House Bill 2139 (Ariz. Sess. Laws 2005, Ch. 39), passed by the Arizona Legislature and signed by the Governor in 2005 provides an optional apportionment formula for calculating corporate income tax for multistate corporations. This formula is favorable to businesses that have substantial payroll on property in Arizona that make a majority of sales out of state. It is intended to encourage additional capital investment in Arizona by both corporations running into the state and corporations with ongoing activities in the state integrate more high-tech, knowledge-based jobs in the state.

Currently, multistate corporations calculate corporate income tax using a combination of Arizona property, payroll and sales, with sales double-weighted. The new option allows corporations to give greater weight (80%) to the sales factor in calculating their Arizona tax liability. The 80 percent sales factor will be phased in over the next three years, with a 60 percent sales factor effective in tax year 2007, 70 percent sales factor in 2008 and an 80 percent sales factor in 2009. The optional apportionment formula becomes effective in tax year 2008 but will be retroactive to 2007 if the following two conditions are met:

1. At least one corporation announces, on or after June 1st, 2005, that it has one or more capital investment projects in Arizona that, individually or collectively, exceed $1 billion dollars and the corporation reports its activity to the Joint Legislative Budget Committee (JLBC) and the Governor's office of Strategic Planning and Budgeting (OSPB). The report must contain a description of the project and the project's estimated completion date, cost and economic impact on the labor force. Intel has already announced that it has planned capital investment projects in Arizona sufficient to satisfy this condition.

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2. The corporation must report to JLBC and OSPB by December 15, 2007, that construction has commenced and verifies that the project's costs will exceed $1 billion dollars.

Given the new 80 percent super-weighted sales factor election coupled with Arizona's repeal of the "throw-back" rule, an Arizona corporation that manufacturers or produces items in Arizona but sells the items to purchasers outside the state, will benefit significantly from this new super-weighted sales factor election, particularly, if the company's sales are to the U.S. government or into a state where the company is protected from state income taxation by Public Law 86-272. As an example, assume that an Arizona company has 100 percent of its property in Arizona, 100 percent of its payroll in Arizona, but sells 100 percent of its product out of state. The property factor would be 100 percent, the payroll factor would be 100 percent but the sales factor would be zero. Under Arizona's existing double-weighted sales factor formula, the apportionment ratio would be 50 percent. However, under the new 80 percent super-weighted sales factor formula, the apportionment ratio would only be 20 percent. And, if Arizona ever went to a 100 percent sales factor election, the apportionment ratio would be zero percent.

(8) Apportionment by Department.

If the UDIPTA allocation and apportionment provisions do not fairly represent the extent of the taxpayer's business activity in Arizona, the taxpayer may petition for or the Department may require any of the following:

(1) Separate accounting.

(2) The exclusion of any one or more of the factors.

(3) The exclusion of one or more additional factors which will fairly represent the taxpayer's business activity in the state.

(4) The employment of any other method to effectuate an equitable allocation in apportionment of the taxpayer's income. A.R.S. § 43-1148.

(9) Apportionment Factors for Special Industries.

Construction Contractors, Airlines and Railroads. The Model regulations under UDIPTA single out construction contractors, airlines and railroads for special apportionment treatment. However, Arizona has not adopted special apportionment factors for these industries. Such corporations are subject to apportionment and allocation in the same manner as other corporations.

Financial Organizations and Public Utilities. While UDIPTA precludes apportionment and allocation of the income of a financial organization or a public utility, such corporations are subject to the Arizona allocation and apportionment provisions in the same manner as other corporations.

Insurance Companies. Insurance companies are subject to the gross premiums tax rather than the income tax. Thus, the UDIPTA apportionment and allocation mechanism does not apply.

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(10) Apportionment Regulations.

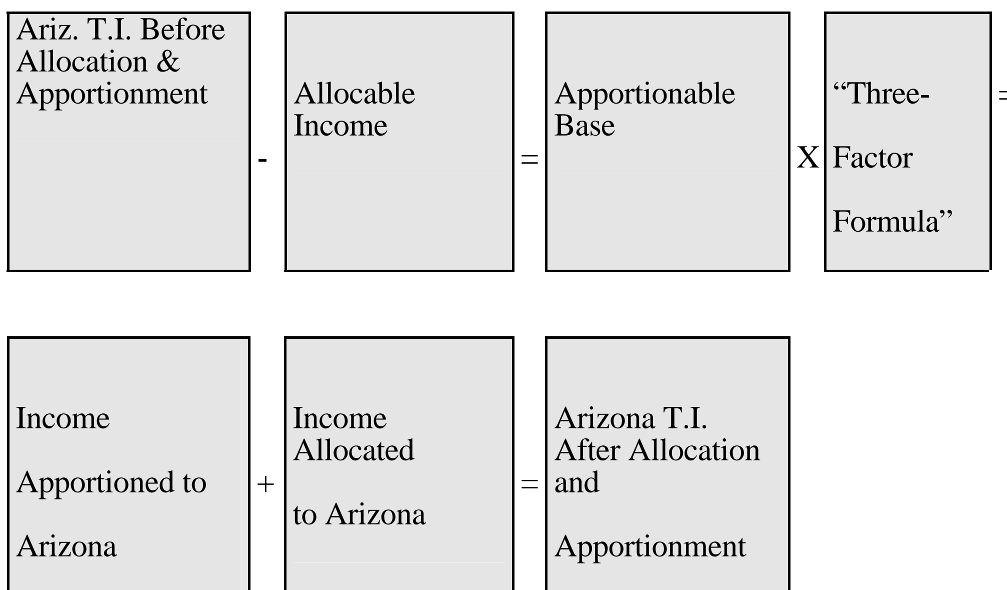
Department of Revenue Regulations. The Department of Revenue has promulgated regulations interpreting and applying the Uniform Division of Income Tax for Tax Purposes Act. Those regulations are found at R15-2-1131 through 1148.

Multi-State Tax Commission Regulations. The Multi-State Commission, of which Arizona is an associate but not regular member, has promulgated regulations under UDIPTA. Those regulations are quite detailed and include apportionment factors for special industries, such as construction contractors, airlines, railroads, financial organizations and public utilities.

(11) Flowchart of Apportionment and Allocation Provisions of UDIPTA.

Following is a flowchart which shows the apportionment and allocation features of Arizona's version of UDIPTA. You'll note that the apportionment and allocation procedures come into play after Arizona taxable income has been determined. That figure, as seen from Chart No. 1, is a result of making the additions and subtractions to federal taxable income to arrive at Arizona taxable income. Since that figure will include both Arizona and non-Arizona source income, it must be adjusted to "weed out" non-Arizona source income. The UDIPTA apportionment and allocation procedures do just that.

ALLOCATION AND APPORTIONMENT FLOWCHART



Example. Assume that ABC Corp., which is the same corporation as in example no. 1 above, has Arizona taxable income of $90. Further assume that ABC Corp. has $10 rental income from real property in Arizona, which is nonbusiness income. Further assume that its apportionment factor (the three-factor formula) is 40%. ABC Corp.'s Arizona taxable income, after apportionment and allocation will be $42, computed as follows: $90 minus $10 (the specifically allocated rental item) equals $80, times 40% equals $32, plus $10 (adding back the

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rental income specifically allocated to Arizona) equals $42. The corporate income rate will be applied against that $42, appropriate tax credits will also be applied, and the result will be Arizona corporate income tax to be paid.

2.8 DISTINCTION BETWEEN BUSINESS AND NON-BUSINESS INCOME

The distinction between business and non-business income is important because business income will be apportioned among all of the states in which the multi-state taxpayer does business in, while non-business income will be allocated to only one state.

The issue usually comes up in a situation where a multi-state taxpayer has income from the sale of property, it could be a plant that is no longer needed, the sale of stock in an affiliated corporation, the sale of a partnership or joint venture interest in a business activity, dividends, royalties, or, perhaps, court awarded damages.

As an example, a business may sell a plant located in a low corporate income rate state or a state that has no corporate income tax at all. If the gain on the sale of the plant were considered non-business income, then it would be allocated in its entirety to the situs state and not apportioned among the several states in which the company does business. If it were considered business income, on the other hand, then it would have to be apportioned and would be subject to tax at the appropriate states' rates, which in this example are higher than the situs states rate (which is a low rate state or no tax state). If the gain were considered to be non-business income, then there would be a potential tax savings. On the other hand, one of the non-situs states may well want to categorize the gain as business income so that it is able to tax its portion of the gain.

Arizona's version of UDIPTA defines "business income" as follows:

> "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations. A.R.S. § 43-1131.1. Non-business income is defined to mean "all income other than business income."

The courts have used two tests to differentiate between business and non-business income, the transaction or activity test and the functional test.

Transaction or Activity Test. Did the transaction or activity occur in the regular course of the trade or business of the taxpayer? If it did, then it is business income.

Functional Test. Was the income producing property integrated into the business operations? If it was, then income giving rise from the disposition of that property will be business income.

To best illustrate the difference between the two tests, assume that a taxpayer sells one of its manufacturing plants. This is the first time that the taxpayer has sold any of its operational property. It does not regularly engage in these types of transactions at all. However,

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the plant is an integral and functional part of its business operations. Under these facts, the transactional test would not be met and the gain on the sale of the plant would be considered to be non-business income. On the other hand, the application of the functional test would characterize the income as business income, since the plant was an integral and functional part of the company's operations, even though the company did not regularly engage in those types of transactions.

The following are some of the more significant business – non-business income cases.

1. *Texaco-Cities Service Pipeline Co. v. Ill. Dept. of Rev.,* 695 N.E.2d 481 (Ill. 1998). Texaco sold a pipeline located in Illinois to a third party. The pipeline was a part of Texaco's operations, which it used to transport oil and other petroleum products it produced. The court concluded that the gain from the sale of the pipeline was business income. The court by necessity had to apply the functional test, because Texaco did not regularly engage in the sale of pipelines. (Illinois Supreme Court).

2. *Ex Parte Uniroyal Tire Co., 779 So. 2d 227 (Ala. Aug. 4 2000).* Uniroyal entered into a joint venture to which it contributed assets and took a partnership interest. The partnership engaged in the manufacture of tires. Uniroyal later sold its partnership interest to Michelin. Uniroyal took the position that the gain from the sale of its partnership interest should be allocated to its state of domicile, which was Connecticut, rather than apportioned to Alabama. In an administrative hearing, the administrative law judge characterized the gain as non-business income using the transactional test. However, the Alabama Circuit Court applied both the transactional and functional tests and found that Uniroyal's gain was business income and should be apportioned to Alabama.

The Alabama Supreme Court, though, reversed the Court of Appeals, holding that Alabama's definition of business income contains only the transactional test. The Court concluded that the second clause of the UDIPTA definition of "business income," which the appeals court concluded established an independent functional test (the "acquisition, management and disposition of the property"), uses the conjunction "and" rather than "or." The Court held that the words "and" and "or" are not interchangeable and their use should be followed unless the construction makes the statute inoperable or the meaning becomes questionable. The Alabama Supreme Court found that by interpreting the word "and" to also mean "or" could "eclipse entirely the transactional test." The Court distinguished the *Polaroid* case, which held that the North Carolina definition of "business income" embodied an independent, functional test, on the basis that North Carolina's definition of "business income," and specifically the second part dealing with the "acquisition, management, and disposition of the property" used the words "and/or" rather than the conjunction "and" as the Alabama definition did.

It should be noted that Arizona's definition of business income uses the conjunction "and" and not "or," or "and/or." Thus, the *Uniroyal* decision should have considerable bearing on Arizona's definition. In fact, it could be argued that following *Uniroyal*, Arizona's definition of business income embodies only a transactional test and not an independent functional test.

3. *Polaroid Corp. v. Offerman,* 507 S.E.2d 284 (N.C. 1998) *cert denied,* 119 s. Ct. 1576 (1999). Polaroid sued Kodak for patent infringement and recovered some $900 million which was composed of some $233 million of damages for "lost profits", an additional $204 million for "loss profits" determined on the basis of a "reasonable royalty" and prejudgment interest in the amount $435 million. Polaroid took the position that the court awarded damages was non-business income, since it was not regularly engaged in suing others and recovering damages. The North Carolina Court of Appeals agreed with Polaroid. However, the North Carolina Supreme Court reversed, concluding that the court awarded damages was business

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income. Again, by necessity, the North Carolina Supreme Court had to use, and did use, the functional test, since the application of the transactional test, by itself, would result in the damages being characterized as non-business income. The court determined that both the lost profits, the lost profits determined on the basis of a "reasonable royalty", and prejudgment interest were all business income, that given Polaroid's recovery constituted income in lieu of profits, that income should be classified as business income because it represents the disposition of assets integral to Polaroid's regular trade or business operations. The court also observed that "the judgment partly represents profits which Polaroid would have earned absent Kodak's infringement. Those profits would have properly been considered apportionable income had they been earned in the normal manner. The fact that they were received in the court room instead of the marketplace is irrelevant. Moreover, the monies received from the Kodak lawsuit were used as part of Polaroid's working capital and therefore constitute part of Polaroid's unitary business". 1998 N.C. LEXIS 727 at p. 20.

Another issue involved in the *Polaroid* case, was whether the definition of "business income" found in UDIPTA included the functional test, or whether it was just a transactional test. The court concluded that the following italicized portion of the definition embodied the "functional test":

> "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business. *And includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.*

Polaroid had argued that the italicized portion of the definition was essentially modifying the transactional test, which is the first part of the definition, and did not set forth a second, independent functional test for business income. Polaroid argued that business income arises from transactions or activities in the regular course of the corporation's trade or business and that the phrase "and includes" merely modifies the first clause by providing examples of what fits within the definition.

The *Polaroid* decision is noteworthy because it concludes that UDIPTAs' definition of business income embodies both the transactional and the functional test, with income being characterized as business income if either of the tests is met.

4. *Hoechst Celanese v. Franchise Tax Board*, 25 Cal.4th 508, 527, 22 P.3d 324, 337 (Ca. 2001). In the *Hoechst Celanese* case, the California Supreme Court took the position that the California definition of "business income" contains both a transactional test and a separate functional test. 25 Cal.4th at 526, 22 P.3d at 336. The court took this position, in part, "in the interests of promoting uniformity" among states that have adopted UDITPA. *Id*. The court included an extensive discussion of the North Carolina Supreme Court's decision in *Polaroid Corp. v. Offerman*, 507 S.E.2d 284 (1998) in support of the position that the UDITPA definition could be interpreted as creating both a transactional and functional test. 25 Cal.4th at 521, 22 P.3d at 333.

In construing the phrase, "acquisition, management, and disposition of the property," the California supreme court rejected the Board's argument that "and" should be given a disjunctive meaning because "'and' is ordinarily conjunctive and because nothing suggests a legislative intent to give 'and' a different meaning." 25 Cal.4th at 528, 22 P.3d at 338.

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After a lengthy discussion of each term in the second phrase of the UDITPA definition, the court concluded that "income is business income under the functional test if the taxpayer's acquisition, control and use of the property contribute materially to the taxpayer's production of business income. In making this contribution, the income-producing property becomes interwoven into and inseparable from the taxpayer's business operations." 25 Cal.4th at 532, 22 P.3d at 340.

The court then noted that its interpretation of California's business income test is consistent with prior California Court of Appeals decisions, and cited favorably, among other cases, *Robert Half International, Inc. v. FTB*, No. A079671 (Ca. Court of Appeals, Sept. 21, 1988). 25 Cal.4th at 532-33, 22 P.3d at 340-41.

5. *Lenox v. Tolson*, 353 N.C. 659; 548 S.E.2d 513 (N.C. 2001). The *Lenox* case involved a conglomerate New Jersey-based corporation, Lenox, with multistate operating divisions engaged in the business of manufacturing and selling numerous consumer products. In 1970, Lenox established its ArtCarved division to manufacture and sell fine jewelry. In 1988, because ArtCarved had not been profitable, Lenox sold all of the assets of its ArtCarved division pursuant to a restructuring plan and seceded from the fine jewelry manufacturing business. Lenox classified the gain as "nonbusiness income" on its North Carolina tax return and did not pay taxes on the gain. The North Carolina Department of Revenue, however, reclassified the gain as business income and assessed corporate income tax, which Lenox paid under protest. Lenox then filed a refund action to recover this amount. The trial court granted the department's summary judgment motion.

On appeal, the North Carolina Court of Appeals reversed the trial court's judgment, stating that, even under that state's broader definition of "business income," when the sale of an asset represents a partial liquidation, the court must "focus on more than whether or not the asset is integral to the corporation's business." *Lenox v. Offerman*, 538 S.E.2d 203 (N.C. Ct. App. 2000). In its opinion, the North Carolina Court of Appeals cited an earlier North Carolina Supreme Court case, *Polaroid Corp. v. Offerman*, 507 S.E.2d 284 (1998), but declined to follow the higher court's lead in applying a "straightforward application of the functional test." *Lenox*, 538 S.E.2d at 205, 207-208. Accordingly, the Department of Revenue appealed the case to the North Carolina Supreme Court.

In taking up the *Lenox* appeal, the North Carolina Supreme Court disavowed its earlier conclusions that the extraordinary nature or infrequency of the transaction is irrelevant and that income from the acquisition, management, and/or disposition of an asset that was integral to a taxpayer's regular trade or business constitutes business income regardless of how the income is received. *Lenox*, 548 S.E.2d at 517. In *Lenox*, the court stated "[t]he wording of these two sentences in *Polaroid* is a cause of confusion, and we hereby disavow these statements." The court went on to explain:

The statements in *Polaroid* are in direct contravention of the functional test of our statute which requires that the 'property constitute [an] integral part[] of the corporation's *regular* trade or business operations.' The source of corporate income cannot be disregarded, as extraordinary or infrequent transactions may well fall outside a corporation's regular trade or business. Again, the focus must be on the asset or property that generated the income and its relationship to the corporation's regular trade or business. To use such overly broad language as we have just disavowed would render the statutory definition of 'nonbusiness income' meaningless. 548 S.E.2d at 517. (Emphasis in original).

The court further stated that "when an asset is sold pursuant to a complete or partial liquidation, the court must focus on more than the question of whether the asset was integral to the corporation's business. Partial or complete liquidations are extraordinary events and are not recurring transactions." *Id*. With regard to Lenox's disposition of its ArtCarved division, the court

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held that the sale "did not generate business income because the liquidation of this asset was not an integral part of Lenox's regular trade or business." *Id.* at 520.

6. *Jim Beam Brands Company v. Franchise Tax Board,* 133 Cal. App. 4th 514, 34 Cal. Rptr. 3rd 874 (2005). A number of state courts have held that the gain on the disposition of a business is to be classified as non-business income. Those states reason that a business is not in the business of going out of business. This has been referred to as the "going-out-of-business exception to the functional test for business/non-business characterization of income. However, in the *Jim Beam* case, the California Court of Appeals ignored the going-out-of-business exception and held that the gain on the sale of a subsidiary gave rise to business income under the functional test. Under the going-out-of-business exception to the functional test, the courts have focused on whether the income-producing transaction, the sale of the stock of the subsidiary, was integral to the unitary business. However, the *Jim Beam* court focused on the income-producing property, which was integral to the unitary business. The *Jim Beam* decision essentially holds that any property used in a unitary business will generate business income.

3. THE "UNITARY CONCEPT" AND COMBINED REPORTING

3.1 BACKGROUND

In order to properly apply formula apportionment, the business operations of the corporation must be unitary. If the in-state business operation of the corporation (*i.e.*, a division) is not engaged in a unitary business with the out-of-state divisions of the corporation, then formula apportionment cannot be used to determine the corporation's Arizona source income. Rather, separate accounting would be used. The Supreme Court has referred to the unitary business concept as the "linchpin of apportionability." *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425, 439 (1980). This phrase, which is the keystone of formula apportionment, means that a state cannot use an apportionment formula to divide the income of a business enterprise unless all the income included in the apportionable base is derived from business activities "unitary" with the business carried on in the taxing state.

3.2 DEFINITION OF UNITARY BUSINESS

A unitary business may be comprised of branches or divisions of a single corporation or of commonly controlled but separate corporations. The criteria usually applied for determining if the operations of a business are unitary include: the percentage of one corporation's common stock owned by another; the sharing of centralized services, such as accounting and advertising; and the type and number of transactions carried between corporate entities. However, no universally agreed-upon criteria exist. GAO Report page 4.

3.3 CLASSIC EXAMPLE OF UNITARY BUSINESS

A classic example of a "unitary" business is a railroad company that owns and operates a national network of railroad lines. The Courts have been willing to view such a railroad business as "unitary" because it operates as an "organic whole." *See, e.g., Nashville C. & St. Louis Ry. v. Browning*, 310 U.S. 362 (1940); *Norfolk and Western Ry. Co. v. N. Carolina*, 297 U.S. 682 (1936). Because the value of the national rail network enhances the value of the in-state rail network, the income from the entire national business may be included in the apportionable base.

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3.4 EXPANSION OF UNITARY CONCEPT TO MULTI-CORPORATE ENTITIES

Originally, the states applied formula apportionment only when the unitary business was a single corporation. For example, a single corporation might encompass administrative offices in a manufacturing plant located in one state with a second plant in another state. To determine how much of the corporation's income was attributable to each state, each of the two states would apply its apportionment formula to the single corporation's entire operation. GAO Report page 4.

In time, the states expanded their definition of a unitary business. These states, most notably California, decided that a unitary business could consist not only of one corporation but of a group of affiliated corporations doing business in several states. As a result, the states began taxing multi-corporate entities in the same manner as single corporations. A state's application of its apportionment formula became dependent upon its determination that a business entity was unitary and not upon a particular corporate structure. For example, a group of separate corporations performing different functions (for example, manufacturing, distributing, selling) in different states but engaged in the same unitary business were treated the same as a single corporation with several divisions conducting business operations in several states. Applying the unitary concept in its broader context, a state would apply its apportionment formula to the combined income of the affiliated group of corporations that made up the unitary business. GAO Report pages 4 and 5.

3.5 METHOD OF IMPLEMENTING THE UNITARY CONCEPT - THE COMBINED REPORT

The Combined Report is an approach for determining the income attributable to a particular state of each corporate member of an affiliated group conducting a unitary business both within and without the taxing state. The determination of the proportionate amount of the unitary income attributable to the activities of the corporation or corporations doing business in the taxing state is generally accomplished by first combining the net income of each of the affiliated corporations and then applying to this base a combined apportionment ratio. The ratio is comprised of the respective total in-state factors of the entire group divided by its total everywhere factors. Related intercompany transactions and transfers are generally eliminated from both the apportionable income base and apportionment formula because they do not usually increase the wealth or profitably of the business but represent a shuffling among affiliated companies of receipts previously generated and accounted for by the individual “units” of the business. If there is more than one member of the affiliated group doing business in the taxing state, the portion of the unitary income assigned to the state must also be apportioned among those members subject to the state's taxing jurisdiction. In practice, this additional step is omitted in many cases and the entire tax is assessed on the return of only one member (the “key corporation") of the unitary group. Combined Reporting "The Approach And Its Problems," Journal of State Taxation, Volume 1, No. 1, Page 5, Spring 1982.

3.6 COMBINED REPORT V. CONSOLIDATED RETURN - DISTINGUISHED

Consolidated Return. Although the terms are often used interchangeably, a combined report is not the same as a consolidated return. Generally, the total income of the corporations within a consolidated group is reported on a single return and a single tax is paid

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thereon for which each member of the group is jointly and severally liable. The consolidated income subject to tax is not limited to an amount related to a specific unitary business.[3] Since states may not ordinarily tax income from sources outside the state or subject corporations not present in the state to tax, a consolidated return generally applies to affiliated corporations subject to the jurisdiction of the taxing state.

Combined Report. In a combined report, on the other hand, the combined income of the affiliated group is not computed for the purpose of taxing such income, but rather as a basis for determining the portion of income from the entire unitary business attributable to sources within the state which is derived by members of the group subject to the state's jurisdiction. Again, it is viewed as more of an informational return than a tax return. Combined Reporting: "The Approach End of Problems," Journal of State Taxation, Vol. 1, No. 1, Page 5, Spring 1982.

3.7 BASIS OF THE COMBINED REPORT - EXTENT OF APPLICATION OF THE UNITARY CONCEPT

The states either permit or require a variety of types of combined reports all depending upon the extent to which the states apply the unitary concept. There are three general bases for applying the unitary concept:

(1) Unitary Business Theory Applied on a Separate Entity Basis.

When the unitary business theory is applied on a "separate entity" basis, the state imposes tax on its apportioned share of all net income derived by the taxpayer-corporation from the corporation's unitary business, part of which is carried on within the state. This was the approach used by the taxing authorities in the following Supreme Court decisions: *F. W. Woolworth v. Taxation and Revenue Department of the State of New Mexico*, 458 U.S. 354, 102 S. Ct. 3128, 73 L. Ed. 2d 819 (1982); *ASARCO v. Idaho State Tax Commission*, 458 U.S. 307, 102 S. Ct. 3103, 73 L. Ed. 2d 787 (1982); *Exxon Corp. v. Wisconsin Department of Revenue*, 447 U.S. 207, 100 S. Ct. 2109 (1980); and *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425, 100 S. Ct. 1223 (1980). This use of the unitary business theory is referred to as "separate entity reporting."

(2) Unitary Business Theory Applied on a Domestic Combined Reporting Basis.

In this application of the unitary business theory, the state imposes tax on its apportioned share of all net income derived by the taxpayer-corporation *and its U.S. affiliates* from a unitary business, part of which is carried on within the state. The state, in other words, seizes upon the presence in the state of one corporate entity that is a member of a group of affiliated corporations, and asserts that the combined net incomes of all U.S. corporations in the affiliated group are includable in the in-state corporation's apportionable base. This use of the unitary business theory is referred to as "domestic combined reporting" or "domestic combination.

[3] If the group is engaged in an interstate business it is necessary to apply an appropriate apportionment formula to determine the part of the consolidated income taxable by a particular state.

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Essential to a state's assertion of the unitary theory on a domestic combined basis is that the corporations included in the combined report be engaged in a business that is unitary with the business carried on by the in-state member of the affiliated group. The due process clause of the U.S. Constitution requires that income from related corporations--or even from separate divisions within a single corporate entity-- be included in the apportionable base of the in-state taxpayer only if the income is from sources that are unitary with the business the taxpayer carries on within the taxing state. *ASARCO v. Idaho State Tax Commission*, 102 S. Ct. at 3112; and *F. W. Woolworth v. Taxation and Revenue Department of the State of New Mexico*, 102 S. Ct. at 3139.

(*3)* *Unitary Business Theory Applied on a Worldwide Combined Reporting Basis.*

In this expanded application of the unitary business theory, the state imposes tax on its apportioned share of all net income derived by the taxpayer-corporation *and its affiliates worldwide* from a unitary business, part of which is carried on within the state. The distinction between worldwide and domestic combination is that states employing domestic combination adopt a "water's edge" approach to determining what corporations will be included in the combined group to arrive at the apportionable base. If the unitary business theory is applied on a worldwide combined reporting basis, the net incomes of all corporations unitary with the in-state corporation are included in that corporation's apportionable base, regardless of the geographical location of the group members. This use of the unitary business theory is referred to as "worldwide combined reporting" or "worldwide combination."

The constitutionality of worldwide combined reporting was upheld by the U.S. Supreme Court in *Container Corporation of America v. California Franchise Tax Board*, 463 U.S. 159, 103 S. Ct. 2933, 77 L. Ed. 2d 545 (1983), to the extent that the corporation which was doing business in California was a domestic corporation with foreign subsidiaries. The constitutionality of the converse situation, where the taxpayer-corporation is a domestic subsidiary of a foreign parent, has yet to be addressed by the U.S. Supreme Court. However, that issue is currently pending in Federal District Court in Chicago and may ultimately end up in the U.S. Supreme Court. *See Alcan Aluminum Ltd. v. Franchise Tax Board*, No. 84-C-6932, U.S. District Ct., N.D. Ill.

4. ARIZONA'S APPLICATION OF THE "UNITARY CONCEPT" AND COMBINED REPORTING

4.1 ARIZONA APPLIES THE UNITARY BUSINESS THEORY ON A "DOMESTIC COMBINED REPORTING BASIS"

Arizona has adopted the "domestic combined reporting" basis, sometimes referred to as the "water's edge" approach. *See* Regulations R15-2-1311 and R15-2-947.A.2 and Laws 1985, Chapter 109, which authorize only a "domestic combined reporting basis" and prohibits a "worldwide combined" reporting basis. Using such a "domestic combined reporting basis," only the income of the reporting corporation and its U.S. affiliates that are engaged in the same unitary business is included in the apportionable base. Income from foreign subsidiaries,

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including dividends, are excluded. Moreover, and for consistency purposes, values from foreign subsidiaries are not included in the denominators of the sales, payroll or property factors.

"80/20" Corporations. An "80-20" corporation was formerly defined as a domestic corporation which derived more than 80 percent of its federal gross income from sources outside the United States. This is also the federal definition of an "80-20" corporation. A.R.S. § 43-1101 now defines an "80-20" corporation as a domestic corporation with more than 80 percent of its property, payroll and sales outside the United States. An "80-20" corporation's values are excluded from the denominators of the three-factor formula.

4.2 ARIZONA'S DEFINITION OF "COMBINED REPORT"

"Combined report" is defined by R15-2-1132.E as follows:

If a particular unitary trade or business is carried on by a taxpayer and one or more affiliated taxpayers united by a bond of direct or indirect ownership or control of more than fifty (50%) and a part of the businesses conducted in Arizona by one or more of the members of the group, the business income attributable to such a member or members shall be apportioned by multiplying the groups of unitary business income by the average of the property, payroll and sales factors. Those factors are determined by dividing the Arizona property, payroll and sales figures by the total property, payroll and sales figures of all the members of the unitary group. The property, payroll and sales factors are to be determined in accordance with the rules described in R15-2-1140 through R15-2-1147. The extent of the unitary business or group is limited to that business which is subject to the tax imposed by and computed pursuant to the Internal Revenue Code, except as provided in A.R.S. § 43-1132. R15-2-1132.E.

4.3 ARIZONA'S DISTINCTION BETWEEN A CONSOLIDATED RETURN AND A COMBINED REPORT

R15-2-947 distinguishes between consolidated returns and combined reports as follows:

A. Definitions. For purposes of this section the following definitions shall apply:

1. Consolidated return. A consolidated return is a single consolidated income tax return by a group of corporations meeting common ownership standards. The member entities may be engaged in diverse businesses and may or may not be operationally integrated. A consolidated return is a consolidation of the separate returns of each affiliated member of the group. Each member entity operating within and without Arizona will apportion income to Arizona based on a separate apportionment ratio relating only to that member. The net income and losses against member entities will be consolidated, offsetting losses against gains.

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2. Combined return. A combined return is required to be filed by a group of commonly owned corporations or businesses which constitute a unitary business because the basic operations of the entities are integrated and interrelated. See R15-2-1132. The total income of the unitary group must be combined and allocated to Arizona for taxation purposes by means of one apportionment formula. The combined report has the same purpose and effect as the apportionment of the net income of a unitary business conducted by a single corporation. A group of corporations operating wholly in Arizona may be required to file a combined return if the group constitutes a unitary business. See A.R.S. § 43-942. In the case of such wholly owned Arizona corporations, 100% of the net income of the unitary business is allocated to Arizona.

B. This Section provides authority for the department to require a consolidated return under certain prescribed situations. This Section provides no authority for two or more taxpayers which operate wholly within Arizona to file a consolidated return. Two or more taxpayers which comprise a unitary business as defined in R15-2-1131 are required to file a combined, not a consolidated return. Discrete, separate and diverse taxpayers must file separate Arizona income tax returns.

4.4 ELECTION TO FILE A CONSOLIDATED ARIZONA RETURNS ON SAME BASIS AS FEDERAL CONSOLIDATED RETURNS

Laws 1994, 2nd Reg. Session, Ch. 41 amended A.R.S. § 43-947 to allow corporate taxpayers an election to file consolidated Arizona income tax returns for taxable years beginning from and after December 31, 1993. In order to file an Arizona consolidated return the taxpayer must file a federal consolidated return. The taxpayer must include the same corporations in the Arizona consolidated return as in the federal consolidated return. The election to file on a consolidated basis is binding for all succeeding taxable years, unless the department consents to a change in filing method. The election must be accompanied by the written consent, signed by an officer, of each member of the affiliated group.

Taxpayers may also file retroactively on a consolidated basis by submitting amended returns on or before December 31, 1994, accompanied by properly executed consent forms. Taxpayers who wish to file on a consolidated basis for prior taxable years must file a consolidated Arizona return for the taxable year beginning from and after December 31, 1985, and for all succeeding taxable years.

Overpayments of Arizona tax resulting from retroactive consolidated filing for taxable years 1986 through 1993 are not refunded, but are allowed as a credit against future tax liabilities over a ten year period at a rate of 10 percent of the total credit per year. Overpayments remaining after the tenth year will be applied against the following year's tax liability and any remaining balance will be refunded. *See* Arizona Corporate Tax Ruling CTR 94-10.

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Laws 1995, Ch. 31, SB 1058 provides that an affiliated group that filed amended returns prior to December 31, 1994, making the consolidated return election, may amend those filings to include any Alaskan native corporations that are a part of the federal consolidated group. The prior years affected by this additional amended return provision are 1985 through 1992. New amended returns must be filed on or before December 31, 1995, making the election to include Alaskan native corporations.

Laws 1998, Ch. 89, SB 1244, allows corporations that meet all of the requirements for consolidation to file retroactive consolidated returns without securing the written consent of all former subsidiaries.

4.5 ARIZONA'S TEST FOR UNITARY BUSINESS

(1) General.

There are four basic requirements that must be satisfied in order to be considered a unitary business for Arizona income purposes. First, there must be a common ownership or control among the unitary group members of more than 50%. Second, the components must share common management. Third, the components must have reconciled accounting systems. Fourth, there must be substantial operational integration between or among the unitary group members. The first three requirements are generally referred to as the "Threshold Requirements."

(2) Regulations.

The Department has detailed its test in Regulation R15-2D-401:

R15-2D-401. Unitary Business and Combined Returns

A. An entity, group of entities, or components of an entity is not a unitary business for apportionment purposes unless there is actual substantial interdependence and integration of the basic operations of the business carried on in more than one taxing jurisdiction. The potential to operate an entity or a component as part of the unitary business is not dispositive.

B. The determination of whether the operations of a taxpayer constitute a unitary business is based on economic substance and not form. Therefore, a unitary business may consist of part of a corporation, one corporation, or many corporations. If the unitary business consists of more than one corporation, the corporations comprising the unitary business shall file a combined return apportioning the business income of the corporations using a single apportionment formula.

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C. The main reason for defining a business as unitary is that its components in various states are so tied together at the basic operational level that it is difficult to determine the state in which profits are earned. Centralized top-level management, financing, accounting, insurance and benefit programs, or overhead functions by a home office are not sufficient for a business to be unitary without further analysis of the basic operations of the components.

D. The following are necessary threshold characteristics for components of an entity, an entity, or a group of entities to be considered a unitary business:

1. The entities comprising the unitary business are owned or controlled, directly or indirectly, by the same interests that collectively own more than 50 percent of the voting stock,

2. The entities or components share common management, and

3. The entities or components have reconciled accounting systems.

E. The presence of the three characteristics listed in subsection (D) is not sufficient for a business to be considered unitary without evidence of substantial operational integration. Factors that indicate operational integration include the following:

1. The same or similar business conducted by components;

2. Vertical development of a product by components, such as manufacturing, distribution, and sales;

3. Horizontal development of a product by components, such as sales, service, repair, and financing;

4. Transfer of materials, goods, products, and technological data and processes between components;

5. Sharing of assets by components;

6. Sharing or exchanging of operational employees by components;

7. Centralized training of operational employees;

8. Centralized mass purchasing of inventory, materials, equipment, and technology;

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9. Centralized development and distribution of technology relating to the day-to-day operations of the components;

10. Use of common trademark or logo at the basic operational level;

11. Centralized advertising with impact at the basic operational level;

12. Exclusive sales-purchase agreements between components;

13. Price differentials between components as compared to unrelated businesses;

14. Sales or leases between components; and

15. Any other integration between components at the basic operational level.

F. Not all of the factors listed in subsection (E) need be present in every unitary business.

G. A manufacturing, producing, or mercantile type of business is not a unitary business unless there is a substantial transfer of material, products, goods, technological data and processes, or machinery and equipment between the branches, divisions, subsidiaries, or affiliates.

1. A transfer of 20 percent of the total goods annually manufactured, produced, or purchased as inventory for processing or sale, or both, by the transferor, or 20 percent of the total goods annually acquired for processing or sale, or both, by the transferee is presumptive evidence of a unitary business.

2. A smaller percentage of goods transferred may be indicative of a unitary business if other characteristics indicating substantial operational integration are present.

H. In a unitary service business, the operations of the various components or entities of the business are integrated and interrelated by their involvement with the central office or parent in delivering substantially the same service. The day-to-day operations of the components or entities use the same procedures and technologies that are developed, organized, purchased, or prescribed by the central office or parent. There usually is an exchange of employees among the components or entities and centralized training of employees.

I. A taxpayer may have more than one unitary business. In this case, it is necessary to determine the business income attributable to each separate unitary business. The income of each business is apportioned using an apportionment formula that considers the in-state and out-of-state factors of the business.

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J. Generally, a conglomerate composed of diverse businesses is not a single unitary business. However, a line or lines of business within the conglomerate may be a unitary business if the operations of the components of the line or lines are integrated and interrelated.

K. All members of a combined return shall determine income using the same accounting period.

1. If the members of a combined return have different accounting periods, the accounting period to be used by the members shall be determined as follows:

a. If the combined return includes the common parent corporation, the parent's accounting period is used.

b. If the combined return does not include the common parent corporation, the accounting period of a member that has a presence in Arizona shall be used. The same group member's accounting period shall be used consistently from year to year.

2. Each member of a combined return that uses an accounting period that is different from the common accounting period determined in subsection (K)(1), shall use one of the following methods to determine the income to be included in the common accounting period:

a. Determine income and related deductions using actual book or accounting entries for the relevant period.

b. Determine income based on the number of months falling within the required common accounting period. For example, if one member uses a calendar year, and the common accounting period ends October 31, 1981, the member will include 2/12 of the income for the year ended December 31, 1980, and 10/12 of the income for the year ended December 31, 1981. Estimates may be necessary if this proration method involves a member's year that ends subsequent to the common accounting period.

(3) *Talley Industries Case*: "Operational Integration" Test.

The question of whether a corporate group, that was not engaged in the same line of operational business, was a unitary business reviewed by the Arizona Court of Appeals in State v. Talley Industries, Inc., 182 Ariz. 17, 893 P.2d 17 (App. 1994), review denied (April

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1995). This case arose prior to Arizona's adoption of UDIPTA and must be viewed in that context. The taxpayer, Talley Industries, and its subsidiaries, were a corporate group but not engaged in the same line of operational business. However, the subsidiaries were subject to the taxpayer's pervasive centralized control. The Department of Revenue argued that that was not enough and that the subsidiaries and the taxpayer had to be engaged in the same line of business ("operational integration"). The taxpayer argued that all that was needed, at least prior to Arizona's adoption of UDIPTA, was "functional integration", meaning that there was centralized control and management, although the various components were not engaged in the same lines of business.

The Court agreed with the Department, holding that operational integration was required for unitary treatment. The Court reversed the Arizona Tax Court and Arizona Board of Tax Appeals which found functional integration sufficient and held that Talley and its subsidiaries were a unitary business.

(4) *The Woolworth Case*: Operational Integration Test Upheld.

F.W. Woolworth Co., Kinney Shoe Corp., and Kinney Service Corp. v. State of Arizona, 1 CA-TX 97-0007 (December 11, 1997), also involved the test to be used to determine whether a business is unitary, or not. Unfortunately, the Court of Appeals reaffirmed the Talley holding, concluding that the proper test in Arizona for a unitary business was the operational integration test, and not the functional integration test, or the three unities. The Woolworth case, unlike Talley, evolved years after Arizona adopted its Uniform Division of Income for Tax Purposes Act Regulations, which contained the fourteen factors for a unitary business. Given Talley and now Woolworth, it seems pretty clear that the Arizona unitary test is operational integration.

(5) *The Sperry Case*: Finance Company is Unitary With Operating Parent.

In Sperry Corp. v. Arizona Dep't of Revenue, 1994 Ariz. Tax LEXIS 27 (April 26, 1994) (Arizona State Board of Tax Appeals, Division 2, Docket No. 874-91-I), the Arizona Board of Tax Appeals was faced with the question of whether a finance company is unitary with the parent operating company. The Board concluded that under the facts of this case, the finance company was unitary.

Background. The Arizona Department of Revenue conducted an income tax audit of Sperry Corporation for the fiscal years 1980 through 1986. During that time, Sperry, also known as Sperry Rand Corporation, was engaged in a wide range of activities with its principal activity being the development, manufacturing, marketing and servicing of commercial and

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defense computer systems and equipment. It also manufactured specialized farm machinery and fluid power equipment.

Sperry filed on a separate return basis in Arizona through the end of its 1983-1984 fiscal year. Arizona adopted the Uniform Division of Income for Tax Purposes Act ("UDIPTA") in 1983, effective beginning January 1, 1984. Thereafter, Sperry filed on a combined return basis in Arizona excluding only its finance subsidiary, Sperry Financial Corporation (previously Sperry Rand Financial Corporation).

The major audit adjustment was the combination of Sperry's subsidiaries, including Sperry Financial, with Sperry, based on the Department's conclusion that Sperry and all its subsidiaries were engaged in a unitary business operation. Sperry objected to the combination of Sperry Financial and went through the administrative appeals process, ending up at the State Board level.

The State Board's Decision. The State Board upheld the Department's combination of Sperry Financial. Sperry argued that Sperry Financial was not properly includable in Sperry's unitary group because it was not operationally integrated with Sperry. After Arizona adopted UDIPTA, it promulgated regulations, A.A.C. R15-2-1131, which established an operational integration test for combination, as opposed to a functional integration test. The regulations first require common ownership, common management and reconciled accounting systems as threshold characteristics for a unitary business. The regulations further provide that the presence of these three characteristics is not sufficient by themselves without evidence of "substantial operational integration." Fourteen factors are then listed which indicate basic operational integration. Those factors include: the same or similar business conducted by components; horizontal development of a product by components; transfer of materials, goods, products and technological data and processes between components; sharing of assets by components; centralized mass purchasing of inventory, materials, equipment, exclusive sales-purchase agreements between components; sales or leases between components; etc. While all fourteen factors need not be present to indicate a unitary business, a significant number of them must be present to indicate substantial integration at the basic operational level.

Sperry argued that Sperry Financial did not meet the operational integration test established by the regulations, because it did not meet the bulk of the fourteen factors. Sperry contended that other than the same general trade name, the financing company had little in common with Sperry. Sperry Financial was not in the same business as Sperry. Sperry was a manufacturer; whereas, Sperry Financial was a financing company. Nor did Sperry Financial share in the technology or development of a common product. And of significant note, all transactions between Sperry Financial and Sperry were completed through arm's-length dealings at fair market value. There was no special pricing or discounts given. The relationship between Sperry and Sperry Financial was arm's-length, the same as a relationship between a business and a bank.

The Department argued, however, and the Board took note of, the fact that Sperry Financial had an exclusive sales agreement to purchase receivables from Sperry and its subsidiaries. Sperry Financial did not purchase receivables or enter into financing arrangements with third-party, non-related entities. It dealt only with Sperry and its subsidiaries.

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The Board's Test--Finance Company Is Unitary If Financing Of Customers Is An "Integral Part" Of Operating Company's Business. The Board found as a matter of fact that Sperry Financial was the financing arm that facilitates the sale of Sperry's products to its customers and concluded as a matter of law that where the financing of customers is an integral part of a parent company's business, the subsidiary credit or financing company performs a basic operating function and is unitary with the parent. The Board did not go down the list of the regulation's fourteen factors and determine which factors were met and which were not for purposes of determining whether the financing company was unitary. Rather, the Board concluded that a financing company performs a basic operating function where the financing of customers is an integral part of the parent's business, adopting what could be called an "integral part" test.

What is unclear is whether the Board's decision and reasoning applies only to "captive" finance companies that do business only with the operating company or whether it would apply to financing companies that also provide financing services to unrelated, third parties. It would seem that the Board's decision should not extend that far, given the Board's reliance and emphasis on the fact that Sperry Financial only dealt with its parent and not others.

Alternative Argument--Apportionment Formula. Sperry also argued that if the Board found Sperry Financial to be unitary, the three- factor apportionment formula should be modified because it does not fairly represent the combined group's business activity in Arizona. A.R.S. § 43-1148 provides specific authority for the use of other apportionment factors if the three-factor formula does not "fairly represent the extent of the taxpayer's business activity in this state."

Sperry contended that if its finance subsidiary was to be included in the combined report, the formula should include intangible property in both the numerator and the denominator of the property factor. As support for its contention, Sperry relied on Sears, Roebuck & Co. v. Franchise Tax Bd. of California (Cal. Super. Ct., No. C248013, December 14, 1983). Although this case was exactly on point, the Board rejected it because it is a California decision, reasoning that is not controlling in Arizona. The Board went on to conclude that Sperry did not satisfy the requirements of the statute, A.R.S. § 43-1148, by showing that the standard three-factor formula did not fairly represent the extent of Sperry's business activity in this state and therefore the Board upheld the use of the standard three-factor formula. Did the Board err by refusing to include intangibles in the property factor? The inclusion would have reduced the Arizona apportionment ratio because the situs of the finance company's intangibles would have been in its domiciliary state, New York. Clearly, the bulk of the financing company's assets were intangible in nature and, if it is to be a part of the unitary group, as the Board concluded, is the Arizona apportionment ratio skewed (upward) because of the non-inclusion of the intangibles?

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4.6 DEPARTMENT OF REVENUE'S CHECKLIST FOR UNITARY BUSINESS

For audit purposes, the Department of Revenue has a checklist, or information document request, for determining whether a taxpayer is engaged in a unitary business with other corporate members. The checklist is comprised of the following sections:

(1) Manufacturing function checklist;

(2) Marketing function checklist;

(3) General, administrative and selling function checklist.

Generally, upon an audit of a multi-state business that may be engaged in a unitary business operation with other related entities, the Department of Revenue will send the checklist to the taxpayer corporation, requesting information concerning the items on the checklist. The Department then uses the response to determine whether the taxpayer is engaged in a unitary business or not.

It should be noted that failure to provide the information requested may result in the imposition of the failure to provide information penalty under A.R.S. § 42-136.C. The penalty is quite hefty and is in the amount of 25% of the amount of any deficiency tax assessed by the Department concerning the audit assessment for which the information was required, unless it is shown that the failure is due to reasonable cause and not due to willful neglect.

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